No. 12019

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

HARRY C. WESTOVER, United States Collector of Internal Revenue, Sixth Collection District of California, and UNITED STATES OF AMERICA,

Appellants,

vs.

AGNES F. SMITH,

Appellee.

APPELLEE'S BRIEF.

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CASES.

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APPELLEE'S BRIEF.

Jurisdiction.

Plaintiff filed claims for refunds of alleged overpayments by her of 1941-1943 Federal income taxes within the period prescribed by law [R. 7, 10]. The Commissioner notified plaintiff by registered mail of the disallowance of these claims on June 11, 1947 [R. 8] and June 10, 1947 [R. 10] respectively. Plaintiff commenced this action in the District Court on August 11, 1947 [R. 28] within two years after the Commissioner's notice of disallowance of both claims in conformity with Section 3772 (a) (2) of the Internal Revenue Code.

The entire alleged overpayment of 1941 taxes was paid to the Collector of Internal Revenue for the Tenth

District of Ohio [R. 6]. A part of the alleged overpayment for the year 1943 was made to said Collector [R. 9] and the balance was paid to appellant Collector who is the Collector of the Sixth District of California [R. 11]. Frazier Reams was the Collector of the Tenth District of Ohio at the time of all of said payments to that District and he has been out of office since January 1, 1944 [R. 9]. Therefore, even though the amount involved with respect to said payments to that District exceeded $10,000, the United States of America was the proper party defendant under Section 24 (20) of the Judicial Code.

Plaintiff filed a motion for summary judgment [R. 35] which was granted by the District Court [R. 46-47]. Judgment of the District Court was entered May 28, 1948 [R. 48-50]. Notice of appeal was filed within sixty days thereafter on July 14, 1948. This Court has jurisdiction of the case under the provisions of 28 U. S. C., Section 1291.

Statement of the Case.

The statement of the case contained in Appellants' Brief from pages 3 to 5 thereof is accurate and fair. We should merely like to add to the facts therein stated, the following:

1. Neither in her Federal income tax return for 1940 nor in any other way at any time has the plaintiff represented or implied to anyone that the Whiting contract did not have a substantial value at the time of the liquidation of the Quickwork Company [R. 6].

2. The negotiation of the contract between the Whiting Corporation and the Quickwork Company was an arm's length deal involving no inter-related interests in which each party bargained for the best possible deal for himself. Plaintiff did not solicit nor receive any advice concerning the tax consequences to the Quickwork Company or herself of the various proposals made during said negotiations or the agreement as finally executed [R. 4, 36-37].

Summary of Argument.

The judgment of the lower court, in holding that the amounts received by the plaintiff under the Whiting contract in 1941, 1942 and 1943 constituted capital gain to her from the exchange of her Quickwork stock, follows the many decided cases directly in point on the question at issue. There is none to the contrary.

The rule of the lower court and the cases cited by it [R. 46-47] is sound in principle, practical and equitable. It has been accepted as settled law for many years and the tax statute has been amended numerous times during that period and Congress has not seen fit to change it.

By contrast, the rule urged by appellants in their brief, completely unsupported by authority, is inequitable and unsound in principle (because it actually taxes real capital gain as ordinary income) and cannot be reconciled with the controlling statutes involved.

ARGUMENT.

I.

The Judgment of the Lower Court Is in Accord With a Substantial Body of Case Law on the Point at Issue; There Is No Authority to the Contrary.

When a taxpayer receives, in consideration for the sale or exchange of an asset, a contractual right calling for uncertain future payments depending upon future contingencies, that contractual right is considered as having no ascertainable fair market value, and the cases have uniformly held that the transaction is not "closed" upon the receipt of the contractual right but remains open as long as payments are made under the contract; the payments thus subsequently received are received in exchange for the original asset transferred. This authority originated with a unanimous Supreme Court decision in 1931 which has not subsequently been questioned by that body, and extends to Tax Court decisions decided within the past few months. But a year ago the Tax Court, in a decision reviewed by its entire membership without a single dissent, applied this rule to a gain realized upon the complete liquidation of a corporation where the facts from the standpoint of the Commissioner of Internal Revenue were far more favorable to him than are the facts in the instant case.

Carter v. Commissioner, 9 T. C. 364 (1947).

The *Carter* case was affirmed by the Second Circuit while this brief was being printed. The Second Circuit Opinion is contained in the Appendix to this brief.

In *Burnet v. Logan,* 283 U. S. 404, 51 Sup. Ct. 550, 75 L. Ed. 1143 (1931), taxpayer sold her stock in one company in exchange for certain cash and the premise of

the vendee to pay her so many cents a ton on ore thereafter mined from certain property in which the first named company had an interest. This occurred in 1916. During 1918, 1919 and 1920, the taxpayer received substantial payments under this contract, but by the end of that period the total amount she had received with respect to her original stock did not exceed its basis. The Commissioner treated the 1916 sale as a closed transaction, and purported to value the contract received in 1916 under a complicated discount formula; consistently, in the tax years involved in that case, 1918, 1919 and 1920, he attempted to tax as income a certain percentage of the total payments received by the taxpayer under the contract. The Supreme Court held that the Commissioner's method of treating the 1916 transaction as closed was erroneous, stating at pages 412, 413:

> "The 1916 transaction was a sale of stock—not an exchange of property. We are not dealing with royalties or deductions from gross income because of depletion of mining property. Nor does the situation demand that an effort be made to place according to the best available data some approximate value upon the contract for future payments. This probably was necessary in order to assess the mother's estate. As annual payments on account of extracted ore come in they can be readily apportioned first as return of capital and later as profit. The liability for income tax ultimately can be fairly determined without resort to mere estimates, assumptions and speculation. When the profit, if any, is actually realized, the taxpayer will be required to respond. The con-

sideration for the sale was $2,200.00 in cash and the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one. Respondent might never recoup her capital investment from payments only conditionally promised. Prior to 1921 all receipts from the sale of her shares amounted to less than their value on March 1, 1913. She properly demanded the return of her capital investment before assessment of any taxable profit based on conjecture."

It will be noted from the above quotation that the Supreme Court repeatedly said that after the taxpayer had recouped her basis, there would then be a *profit* upon which she must pay a tax. Since the word "profit" rather than "income" was used, and since the "profit" would be realized only after the basis of the *asset originally sold* was recovered, the Supreme Court was undoubtedly referring to the profit on the sale of the original asset, as distinguished from the contingent contract.

It is true that the *Logan* case did not involve the capital gains provisions, and did not require a direct holding that the payments subsequently received on such a contingent contract should be considered for tax purposes to be received in exchange for the original assets surrendered. Yet, that is the obvious and necessary import of the *Logan* decision. Under the present applicable statute—and it has not been changed for years in this respect—the determina-

tion of gain or loss from the sale of an asset is controlled by Section 111 of the Internal Revenue Code (the section involved in the *Logan* rule cases) regardless of whether the asset is or is not a capital asset. And it must necessarily follow that if the original transaction is not "closed" —to use the Supreme Court's language—the subsequent payments must relate to it. The Courts have unanimously so interpreted the *Logan* decision, and have repeatedly reiterated the Supreme Court's view that a transaction may be either "open" or "closed" for tax purposes.

The *Logan* case has been applied in a uniform series of cases involving a sale of patent rights or similar property for a consideration based upon subsequent production or profits.

> *Commissioner v. Hopkinson,* 126 F. 2d 406 (C. C. A. 2d 1942);
>
> *U. S. v. Yerger,* 55 Fed. Supp. 521 (D. C. Penn. 1944);
>
> *Haynes v. U. S.,* 50 Fed. Supp. 238 (Ct. Cl., 1943);
>
> *Phillip W. McAbee,* 5 T. C. 1130 (1945), at 1151;
>
> *Edward C. Myers,* 6 T. C. 258 (1946);
>
> *Carl G. Dreymann,* 11 T. C. 153 (1948).

These cases hold that the subsequent payments received year after year constitute capital gain and are taxable as such if the asset originally sold was a capital asset and had been held for the required length of time at the time of sale. At pages 16 and 17 of Appellants' Brief, an attempt is made to distinguish these cases and others which

amply support them in principal[1] with the bland statement that they involved sales on the installment plan "with the purchase price to be discharged by future payments." There is no such difference. For the purpose of the present issue the cases are identical with the instant case, neither of them constituting an "installment" sale, and all of them possessing the same installment—that is, periodic payment-characteristics.

None of the above cases involved a gain upon the surrender of corporate stock in complete liquidation of a corporation. However, it is conceded at pages 8 and 9 of Appellants' Brief that the Internal Revenue Code prevents any differentiation in tax treatment because of that fact. Section 115(c) thereof specifically provides that the amounts received from a corporation in complete liquidation of its stock shall be treated as in full payment in exchange for the stock, (thus entitling liquidations to capital gain and loss treatment) and the gain or loss to the stockholders so resulting shall be determined under Section 111. Section 111 is the section which controls

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[1]In view of the many cases directly in point on the question at issue, it is felt there is no need of lengthening this brief by the discussion of numerous analogous cases which have applied the *Logan* doctrine under all tax statutes subsequent to the *Logan* decision and down to the present time. Some of these cases are:

Perry v. Commissioner, 152 F. 2d 183 (C. C. A. 8th, 1945), the Court citing with approval at page 186 the following language of the Tax Court:

> " 'The very fact,' said the Court, 'that the statute' uses fair market value instead of mere 'value' indicates intent not to permit the inclusion in income of any contract merely because of intrinsic value."

Hills Estate v. Maloney, 58 Fed. Supp. 164 (Dist. Court N. J., 1944);

Imperial Type Metal Company v. Commissioner, 106 F. 2d 302 (C. C. A. 3rd, 1939);

Cassatt v. Commissioner, 137 F. 2d 745 (C. C. A. 3rd, 1943).

the taxation of all sales or dispositions of property, and it or its preceding counterpart was involved in all of the above cases. That is, the above cases held that if a contract is so contingent as to have no "ascertainable fair market value" under the rule of the *Logan* case, it does not have a "fair market value" under Section 111(b) and therefore the determination of the gain is left open until the contingent contract received is paid out. Clearly a gain upon a complete liquidation must be governed by the same rule since it is governed by the identical statutory provision.

It was so held in the recent unanimous case of *Susan J. Carter,* 9 T. C. 364 (1947) (affirmed by the Second Circuit; see Appendix to this brief.) In the *Carter* case Oil Trading Company, Inc. (hereinafter referred to as "the Corporation") was a corporation engaged in the oil brokerage business. It would secure customers for various sellers of oil. The contracts for the sale of the oil frequently provided that the purchaser would buy an approximate amount of oil, or the entire production at a particular locality, for a certain period, or a certain number of tank cars of varying capacity. The Corporation's contract with the seller entitled the Corporation to a commission of 1¢ per barrel on all oil delivered under the contract. In view of the uncertainty of the amount of oil under a particular contract, it could not be determined at the time of the execution of the contract just what the total commission would be.

In 1943 the Corporation liquidated and dissolved. and transferred all of its assets, including 29 brokerage contracts and 3 others of a similar nature—where the amount of the commission was subject to future contingencies of

the type above summarized—to the taxpayer, its sole stockholder, in exchange for her stock in the corporation. In the year 1943 the taxpayer received $43,640.24 as commissions under these contracts. She reported this sum as capital gain realized upon the exchange of her stock in liquidation and the Commissioner claimed that it was ordinary income. This issue was determined in taxpayer's favor, and in view of the similarity between this case and the instant one, the reasoning of the Court on this issue is set forth hereinafter at length (9 T. C., 370):

> "After examination of the authorities adduced, and many others, we are of the opinion that the collections upon the property just here involved (where no services are to be performed by the distributee) are (except as to minor amounts hereinafter examined) to be regarded as capital assets, and gain calculated at capital gain rates. In *Burnet v. Logan, supra,* the Supreme Court considered a situation where a sale of stock was made, payment to be made in proportion to ore mined, so that the market value of the agreement to pay could not be determined with fair certainty. The Court said that it was not necessary to place some approximate value on the contract for future payments, that, as payments on account of extracted ore come in, 'they can be readily apportioned first as return of capital and later as *profit.* * * * When the *profit,* if any, is actually realized, the taxpayer will be required to respond. * * * The transaction was not a closed one. * * * She properly demanded the return of her capital investment before assessment of any taxable *profit* based on conjecture.' (Italics supplied.) Thus, it is clear that, if there is a sale (or exchange) in part in consideration of a contract without ascertainable fair market value, taxation is deferred until collection under such con-

tract, and tax will be upon the *profit* over cost basis, and not upon ordinary income. This is answer to respondent's idea that Susan J. Carter's recovery of her cost basis in the primary distribution distinguishes the *Logan* case. Profit on a capital transaction is not ordinary income; and, under section 115(c) of the Internal Revenue Code, there was exchange of stock in payment for the contracts distributed—a capital transaction. The respondent says it was a closed transaction. The *Logan* case says the transaction there 'was not a closed one.' Is there any reason, in the fact of exchange involved in liquidation rather than ordinary sale or exchange, to distinguish the *Logan* case from that here involved? We can find none. Both are sales, or exchanges, of capital assets (stock) for contracts of no ascertainable value. Section 115(c), in our view, requires us to make no distinction. The *Logan* case speaks of *profit,* not ordinary income, after recovery of basis, and the transaction here is no more required to be treated closed than in that case. Nothing in the nature of liquidation distribution is seen to require an immediate closing, more than in an ordinary exchange, and the language of section 115(c) provides no exception, in case of distribution of unascertainable values, from its mandate to regard the distribution as received in payment in exchange for the stock—and it immediately thereafter treats of 'gain or loss to the distributee resulting from such exchange.' We think that such a distributee, after realization on the contracts of more than cost basis, had gain requiring treatment under section 117.

Bessie B. Hopkinson, 42 B. T. A. 580; affd., 126 Fed. (2d) 406, is, in effect, the same as the *Logan* case, upon which it in part relies. There, a patentee conveyed his patent rights in consideration of an

agreement to make payments based upon manufacturing done under the patent rights. After receiving under the contracts amounts exceeding his cost or other basis, the patentee placed the contracts in trust for his wife, the petitioner in the case. The question at issue was whether payments thereafter received by the beneficiary were ordinary income or capital gain. We held that they were capital gain, saying that, 'In contemplation of law, every payment * * * was, * * * part of the purchase price of a sale of capital assets.' It will be noted that the cost basis had been recovered, as here. In *Haynes v. United States,* 50 Fed. Supp. 238, the Court of Claims held that one who sold capital stock for cash, plus a promise to pay according to the amount of oil and gas produced from the properties involved, was taxable upon such payments when received as profits from sale of capital assets, under section 117(a) of the Revenue Act of 1936, and not as current income. In *George James Nicholson,* 3 T. C. 596, the petitioner in 1931 sold corporate stock in consideration of cash, in excess of his cost basis, and 2 cents a gross ton of stone produced and shipped by the corporation. In later years he received payments under the contract. We held that they were taxable as capital gain, 'since, as we have seen, they are periodic payments for the property sold in 1931.' In *United States v. Yerger,* 55 Fed. Supp. 521, partnership assets were in 1913 transferred to a corporation in consideration of transfer to the partners of corporate stock and agreement to pay them a percentage of the corporate profits for 5 years. A partner assigned his interest in the profits to the defendant, who in 1936 received payments under the agreement. Citing the *Logan* and *Hopkinson* cases, the court held that, 'where there is a right to receive the consideration for capital assets in in-

stallments, or upon contingencies, the transaction is not a closed one. * * * It has no ascertainable fair market value,' and that the defendant's share of corporate profits were payments upon the purchase price of capital assets, as distinguished from ordinary income. The court relied upon *Imperial Type Metal Co. v. Commissioner*, 106 Fed. (2d) 302, affirming 38 B. T. A. 1531, involving the same company and transaction, where it was held that the payments were capital expenditures upon purchase price for capital assets and not business expense deductible by the corporation.

The respondent attempts to distinguish the above cases, urging that petitioner did not sell or exchange the contracts; that is, did not sell or exchange capital assets. The distinction is, in our view, untenable. She did, under section 115(c), exchange capital assets—her stock. *Helvering v. Chester N. Weaver Co.*, 305 U. S. 293. Under the above authority, we hold that the petitioner's income from the contracts so far considered was taxable as capital gain."

The instant case is a stronger case from the taxpayer's standpoint than was the *Carter* case. In the latter the commissions under the contract would have been ordinary income if received by the corporation. However, they were transformed into capital gain as a result of the liquidation. In the instant case, the corporation itself—Quickwork—sold the assets with which produced its income, (plus a small inventory) which assets are ordinarily regarded in business and legal channels as "capital assets." It so happened that under the tax law applicable to the year 1941, the part of those assets constituting depreciable property, *i. e.* the patents, would not be considered as capital assets for tax purposes, although the

rest would be so considered. However, under the income tax law applicable to the year 1943, the gain from all of such assets would be treated as capital gain.

> I. R. C., Section 117 (j);
>
> *Snell v. Commissioner,* 97 F. 2d 891, (C. C. A. (5th) 1938);
>
> *Harry B. Golden,* 47 B. T. A. 94 (1942).

Thus in the instant case, if Quickwork had continued to receive the Whiting payment, a large part of them would have constituted capital gain to it in 1941, and virtually all of them would have constituted capital gain to it in 1943. Her position is thus much stronger than that of the plaintiff in the *Carter* case.

The Second Circuit unanimously affirmed the *Carter* case while this brief was being printed. The entire opinion is contained in the Appendix to this brief.

As opposed to the above cases directly in point and unanimously supporting the judgment of the lower court, appellants have marshaled only four authorities worthy of mention. Two of these, *Boudreau v. Commissioner,* 134 F. 2d 360 (C. C. A. (1st) 1943), and *Fleming v. Commissioner,* 153 F. 2d 361 (C. C. A. (5th) 1946) (App. Br. pp. 15, 16, 18), both rejected a stockholders' claim that the gain upon the complete liquidation of his stock should not be considered a closed transaction because of the difficulty of valuing certain of the assets received. The *Boudreau* case involved an oil interest, which the trier of fact in the lower court had found to have an ascertainable fair market value and had actually valued at a specific figure. This

case has no bearing on the present one since here it is admitted that the contract involved had no ascertainable fair market value. The *Fleming* case involved the receipt in liquidation of a fee interest in land subject only to the interest of a lessee in an outstanding oil lease. Thus the stockholders had received the most absolute type of property interest, a fee interest in land. The difference between that sort of property and the unsecured contingent contractual right involved in the instant case and the *Logan* cases is obvious and need not be expounded. In any event, the appellants are apparently not relying upon the *Boudreau* and *Fleming* cases which required the valuation of the property when received; appellants' position apparently is not that the Whiting contract should have been valued at some figure by the plaintiff when received by her in 1940, but rather that since it had the uncertain qualities of a *Logan* contract and the basis of her Quickwork stock had been recovered, the Whiting contract must have been valued at zero in 1940.

If the Whiting contract had been considered by the parties in 1940 to be worthless, and it could have been properly valued at zero at that time and was so valued, then there would have been a closed transaction in 1940, the contract itself would then have acquired an independent basis of zero, and any subsequent payments thereon would be upon the contract rather than in exchange for the stock and thus would constitute ordinary income. However, in the instant case it is conceded that the contract had a very substantial value when received in 1940, but the amount of that value could not be determined. This being so, under the law the gain on the exchange of the stock remained open, and the contract did not acquire an independent basis of its own.

In the *Puelicher case,* (App. Br. p. 14) the taxpayer inherited a judgment against the bondholders committee—as such and not personally—of an insolvent water company. The judgment "had no fair market value at that time" (6 T. C. 301). At a later date she received certain payments on the judgment and claimed them as capital gain. Since neither she nor anyone else had sold or exchanged anything, the Court properly held that there could be no capital gain. That was the only point that case discussed or determined. It has no bearing on the instant case since here the taxpayer did sell or exchange something, namely, her stock in the Quickwork Company. Furthermore, it may well be that the Tax Court meant by its statement that the claim had no fair market value when inherited, that it was worthless. If so, the claim itself must have had an independent basis of zero to the taxpayer so that subsequent payments thereon must have been with respect to the claim rather than with respect to some earlier asset of the taxpayer. When property is inherited in an estate, there are strong practical reasons which require its being given a value at that time even though the value is rather speculative. The estate must be closed and inheritance taxes must be computed. As a matter of fact in the *Logan* case itself, the taxpayer had inherited a part of the contractual rights involved from her mother and that part had been valued in her mother's estate; the Supreme Court recognized that this "probably was necessary in order to assess the mother's estate." Yet, when it was faced with an income tax problem where there was no pressing necessity of a value

based upon guesswork, it chose the more practical and fair solution of leaving the matter open until the actual payments were received on the contract.

Finally in appellants' fourth case. *Kieselbach, et al. v. Commissioner,* 317 U. S. 399, 63 Sup. Ct. 303, 87 L. Ed. 358 (1943), the taxpayer claimed that that part of a condemnation award actually consisting of interest at six per cent per annum on the value of the property, as determined at the time of taking, from the date of taking to the date of payment constituted capital gain. In that case the judgment involved actually determined how much was owing the taxpayer for his property—the value thereof at the time of taking—and how much was owing him for delay in paying for it. Obviously the latter was interest and must have been taxed as ordinary income. In contrast, in the instant case, there is nothing to indicate that the parties gave any consideration to the value to either of them of the fact that the payments were spread out over several years of time. The spreading out was a necessary result of the method the parties used in determining the purchase price. There was no thought of discount or interest. Be that as it may, the *Kieselbach* case did not tax the entire payment as ordinary income, but only the interest.

The above summary of the pertinent case law on the instant problem has thus demonstrated that there are numerous cases directly in point and that the holding of the lower court in the instant case is in conformity with all of them.

II.

The Rule Adopted by the Judgment of the Lower Court Is Sound, Equitable and Practical.

Long before we had an income tax law it had become common practice to measure the sales price of capital assets of an uncertain value—particularly patents—by a percentage of sales thereafter or profits from said sales. *Littlefield v. Perry,* 21 Wall. 205, 22 L. Ed. 577 (1875). Since our income tax law requires the computation of income on an annual basis and differentiates between capital gain and ordinary income the proper treatment thereunder of the payments received under such a contract has posed a difficult problem for the Commissioner and the Courts. There are three possible solutions:

1. It could be required that all such contracts be valued at some figure at the time of receipt regardless of the margin of error in such determination; capital gain or loss would then be determined in that year based on that figure; the contract received would then acquire a basis of its own equal to the value then placed upon it, subsequent payments on the contract would be tax-free to the extent they did not exceed that basis, and the remainder would be ordinary income. (Such payments might be treated entirely as a return of capital until the basis of the contract was recovered after which they would be 100% income, or, in the alternative, a percentage of each payment could be allocated to capital and income.)

This was the method used by the Commissioner and condemned by the Supreme Court in the *Logan* case. The objections to it as there set forth are: (a) Tax liability is predicated upon guesswork—the uncertain value of the contract; (b) a taxpayer is required to pay a tax on a

gain which he never receives in dollars and, because of the contingent nature of the contract, may never receive, and (c) the taxpayer is required to pay when he has neither received the cash to make the tax payment nor any asset upon which he can realize, by loan or otherwise, with which to pay.

2. The appellants have developed a new suggested solution of the problem obviously calculated to avoid the barrier of the *Logan* decision. Their view is that the contract should be valued at zero (App. Br. pp. 16, 17 and 18), and that after the original basis of the stock transferred has been recouped, all subsequent payments on the contract must be reported as ordinary income. This view cannot be reconciled with the pertinent provisions of the Internal Revenue Code as will be pointed out hereinafter. But for the present, analyzing it only on principle with reference to the *general* pattern of our tax law, it is patently unsound because it taxes real capital gain as ordinary income. Let us assume, for example, that the Quickwork patents had been owned by the taxpayer, and two other taxpayers A and B, in equal interests as tenants in common, each interest being held at a basis of $10,000; that the purchaser was willing to pay each of them $100,-000 cash for his interest, but each of them was demanding $200,000 in cash therefor. Let us assume that the purchaser negotiated with each of them separately and finally agreed to pay A $150,000 in cash, B $150,000 in ten $15,000 annual installments, and plaintiff taxpayer 2% of the gross sales of the Quickwork line over a ten-year period, which 2% happened to amount, as the facts developed, to $15,000 a year for ten years. Appellants must concede that A could report his entire $140,000 profit as capital gain, and B could include a proportionate part of

his $140,000 profit in his income tax returns for the ten subsequent years, all of which would be taxed as capital gain. I. T. 1737, II-2 C. B. 44. Yet the appellants' rule would require the plaintiff taxpayer to treat her *entire* $140,000 gain as ordinary income.

The important fact in the instant case is that the Whiting contract when received had a very substantial value and all of the parties recognized that it had such a value. Thus, the taxpayer's stock likewise possessed that value. There is no reason in principal or otherwise why, because of the difficulty in arriving at the true measure of that value, that the realization thereof must be taxed entirely as ordinary income. The situation is entirely different from that which would exist if the value were wholly speculative and probably non-existent. So in the hypothetical case above supposed, if taxpayer had accepted the offer of $100,000 for her interest, she could have reported the gain as capital gain, but because she felt it was worth more and agreed on a method of valuation subject to future contingencies which vindicated her judgment, she would lose entirely the advantage of the capital gain provisions and be required to report as ordinary income, not only the $50,000 in excess of the $100,000 figure which everyone agreed was the minimum value, but also the $90,000 gain based upon that minimum accepted value.

In view of these results, it is not surprising that no Court to date has adopted appellants' theory.

3. The final alternative solution of the problem is that adopted by the lower court, the *Logan* case and those following it: Hold the transaction open until the contingent contract is paid out and treat the payments on the contract as being received in exchange for the asset originally sold. Under this method the taxpayer's taxes are computed on

the basis of actualities rather than guess-work. And it has the practical advantage comparable to the installment sales method of requiring payment of taxes only after the taxpayer receives the funds with which to pay.

This solution has appeared to be the most sound to all of the Courts that have been faced with this problem. The only possible weakness in it is that it ignores the interest element, if any, in such a transaction which compensates the seller for his consenting to be paid for his capital asset over a number of years. But because of the character of the transactions in which contingent contracts are received in payment, it is usually evident that the parties have not given any consideration to this "interest" element. And there are numerous instances in the tax law where the Courts have refused to create or imply an interest element in order to treat as ordinary income a percentage of a lump sum capital payment. Thus, if property is sold upon an installment basis and there is no specific provision for interest on deferred installments, no interest payment will be implied and the entire payments will be considered as made in exchange for the property.

I. T. 2674, XII-1, C. B. 96;

MacDonald v. Commissioner, 76 F. 2d 513, (C. C. A. 2nd, 1935);

Daniel Brothers Company v. Commissioner, 28 F. 2d 761 (C. C. A. 5th, 1928);

Henrietta Mills, Inc. v. Commissioner, 52 F. 2d 931 (C. C. A. 4th, 1931).

Again if A sells property to B in consideration for B's promise to pay A a certain annuity for life, B must capitalize the entire amount of each annual payment and cannot deduct part of it as interest.

> *Citizens National Bank of Kirkville v. Commissioner,* 122 F. 2d 1011 (C. C. A. 8th, 1941);
>
> *Corbett Investment Company v. Helvering,* 75 F. 2d 525 (App. D. C., 1935);
>
> *Steinbach Kresge Co. v. Sturgess,* 33 Fed. Supp. 897 (D. C. N. J., 1940).

Compare:

> *John C. Moore Corp. v. Commissioner,* 42 F. 2d 186 (C. C. A. 2nd, 1930).

But even if we were to concede, contrary to the facts, that in the instant case the parties did have in mind this interest element the result would be that the lower court had taxed as capital gain not only the true capital gain but also the interest element. The appellants' cure for this slight weakness in the *Logan* rule is not merely to cure the defect but to compound the error by treating not only the interest element but the entire capital gain as ordinary income. It should be noted in this connection that the *Logan* case actually involved only an attempt to tax the "interest" element of the payment as determined by the Commissioner, and this attempt failed. Certainly our Supreme Court would not permit the taxing as an "interest element" of the entire payment.

It is submitted that, in view of the above, the solution reached by the lower court and the *Logan* cases to the instant problem is the best possible solution, and is far preferable to that suggested by the appellants.

III.

The Rule Advanced by the Appellants Cannot Be Reconciled With the Statute, Whereas the Judgment of the Lower Court Is Consistent With It.

Let us assume that A, who holds a capital asset at a basis of $10,000, sells it to B for nothing except a contingent contract of the *Logan* type. In the subsequent year he receives $10,000 on the contract and in the following year an additional $10,000. Appellants did not carry their "zero basis" theory to its logical conclusion which would require that the first $10,000 received be treated as ordinary income. They could not do so in the face of the *Logan* case, and therefore attempted to distinguish that case on the ground that there the taxpayer had not recovered her original basis at the time the Commissioner attempted to tax her on the transaction. (App. Br. p. 10.) If the appellants were asked why the first $10,000 did not constitute ordinary income they would no doubt reply that it constituted a return of capital. If they were then asked "what capital?" they would no doubt reply "the capital invested in the asset sold." If they go this far they must admit that the first $10,000 received is received in exchange for the original asset sold. If this be true, the last $10,000 must likewise be treated as received in exchange for the original asset sold. So far as the law of contracts and the intention of the parties are concerned, every dollar received has the same character; that is, it is paid in exchange for the same consideration. So far as the purchaser is concerned, he would not even care about

the seller's basis, and would have no interest in reaching the point where the seller has recouped his basis. Obviously, in his mind, everything he pays is in exchange for the same thing.

This being so, it is impossible to reconcile the appellants' theory with the tax statute. Once the position is asserted that the contingent contract has a basis of zero, then it must logically follow under the statute that *all payments received* thereon thereafter, even before basis is recouped, constitute ordinary income.

Thus, we must remake the statute if we are to accept the appellants' theory. In contrast, the *Logan* rule as applied by the lower court ties perfectly into the language of Section 111(b). That section requires the gain to be based upon the "sum of any money received plus the fair market value of the property (other than money) received." This statutory language has remained virtually unchanged since 1924. Since that time numerous cases have applied the *Logan* doctrine to it and have held that a contract which has no ascertainable fair market value can have no fair market value. Thus the gain is computed as the cash comes in under the contract. To use the language of the Tax Court in the *Perry* case cited with approval by the Eighth Circuit in affirming it, *Perry v. Commissioner,* 152 F. 2d 183 (C. C. A. 8th 1945 at page 186):

> "The very fact * * * that the statute uses "fair market value" instead of mere "value," indicates intent not to permit the inclusion in income of any contract merely because of intrinsic value."

This interpretation of the section has been recognized not only by the cases in point hereinabove discussed, but also by the leading text on the subject. Mertens, "Law of Federal Income Taxation" (1942), Vol. 10, page 433,

> "On the other hand, Congress undoubtedly recognized that under certain circumstances it was possible for property at a given time to have no fair market value."

Furthermore, at least for the last fourteen years, the Commissioner's own regulations under Section 111(b) have recognized that in certain "rare and extraordinary cases" property may have no fair market value. Thus, Article 111-1 of Regulations 86 under the 1934 Revenue Act provided that "the fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value." This identical provision has been contained in every subsequent regulation and is presently contained in Regulations 111, Section 29.111-1. The Courts have unanimously held that a contingent contract such as the one presently involved is that rare type of property which has no ascertainable fair market value. This has been the accepted case law for sometime and Congress has changed the statute on many occasions without making any change in the controlling language of Section 111(b).

It is submitted, therefore, that the opinion of the lower court is in conformity with the controlling statute, whereas the suggested interpretation of appellants cannot be reconciled with it.

IV.

Appellants Attempt to Distinguish the Present Case From the Logan Case Is Lacking in Substance.

At pages 10 and 11 of their brief, appellants attempt to distinguish the present case from the *Logan* case. We may dispose of these purported differences summarily in the order there set forth:

(1) The Present Transaction Involves an Exchange Whereas the Logan Case Involved a Sale.

In the *Logan* case the taxpayer transferred stock and received in exchange cash and a contingent contract. In the instant case the taxpayer surrendered her stock in the Quickwork Company and received in exchange cash, certain other assets and a contingent contract. There is no difference in substance between the two situations. The fact that the Supreme Court in the *Logan* case emphasized that that case involved a sale rather than an exchange is no doubt due to the peculiar provision of the 1918 Revenue Act there involved. Section 202(b) of that Act provided with respect to exchanges that gain or loss upon an exchange would be recognized only if the property received had a fair market value. Otherwise such exchanges were completely tax-free. This treatment applied to exchanges only and not to sales, *Geary v. Commissioner,* 6 B. T. A. 1109, 1112 (1927), where the Board said with reference to a comparable provision of the 1921 Revenue Act:

> "The provision of the statute that where property is exchanged for other property no gain or loss is recognized unless the property received in exchange has a readily realizable market value, is applicable only to exchanges of property and not to sales."

This explains why the Supreme Court was careful to distinguish between a sale and an exchange under the 1918 Act.

Furthermore, there is no significance whatsoever to the peculiar language of Section 115(c) treating a liquidation as an "exchange" and as "full payment." Hardly more is needed than a reference to the legislative history of this section. It was introduced into the law in the 1924 Revenue Act with the following explanation by the House Ways and Means Committee, C. B. 1939-1, part 2, page 249:

> "The proposed bill as in the 1918 Act treats a liquidating dividend as a sale of the stock to the corporation and recognizes the true effect of such a distribution."

What more eloquent evidence could be asked that Congress intended to apply no magic meaning to the word "exchange," when in their very Committee Report they refer to it as a "sale." Indeed it has been held that a surrender of stock by a stockholder in complete liquidation constitutes a "sale" as that term is used in other provisions of the Internal Revenue Code.

> *Helvering v. Syndicate Varieties,* 140 F. 2d 344, 346 (C. C. A. D. C. 1944).

(2) In the Present Case the Taxpayer Has Recovered Her Basis Whereas in the Logan Case That Was Not So.

In the preceding sections of this brief, we have dealt completely with this asserted difference and have pointed out that the statute does not permit any difference in treatment based upon this ground.

(3) (4) In the Logan Case the Taxpayer Received the Contingent Promise of the Whiting Corporation Rather Than the Contingent Promise of the Quickwork Company to Which She Transferred Her Stock.

This is clearly a distinction without a difference. The taxpayer acquired no greater rights against the Whiting Corporation through the liquidation than she would have received had she exchanged an asset directly to it for such a contingent promise. The same contingencies inherent in the Whiting contract when it was received by the Quickwork Company were inherent in it when it was received by the taxpayer from the Quickwork Company. If it was the type of promise which has "no ascertainable fair market value"—and it is admitted in this case that it does fall within that category—then it has no "fair market value" as that phrase is used in Section 111(b). It matters not, under the language of that section or under the principles established by the cases, whose promise it is.

(5) The Logan Case Did Not Involve the Capital Gains Provisions.

We have dealt with this asserted difference also in previous sections of this brief and pointed out that under the statute, since Section 111(b) governs the computation of gain on both the sale of capital and non-capital assets and makes no distinction between the two, the asserted difference must fall.

The most eloquent final answer to all of the above asserted differences is that when they were presented to the various courts in the cases in point previously discussed there were properly considered to be lacking in substance.

Conclusion.

In the instant case the taxpayer owned a very valuable capital asset—all of the stock of the Quickwork Company. She received in exchange therefor a contingent contract of no ascertainable fair market value. She desires to pay the Government the entire taxes due it on the gain ultimately received by her from the disposition of her stock in the complete liquidation of the Quickwork Company. She feels that she should not be denied this privilege merely because of the fact that the amount ultimately received for such capital asset depends on future events and contingencies.

The instant transactions were motivated purely by business considerations on the part of the taxpayer and her corporation. She did not even seek tax advice concerning the consequences to her of these events. This is eloquently proved by the fact that in her 1940 income tax return, she reported the receipts under the Whiting contract which she received after the liquidation as ordinary income and let the statute of limitations run without filing a claim for refund based upon their proper treatment as capital gains. Thus we are not involved with a situation where the taxpayer attempted to utilize the *Logan* doctrine to secure a tax advantage where business considerations would dictate a different process. The entire present transaction was based wholly upon business considerations.

The judgment of the lower court is in accord with all of the decided cases on the subject, is in conformity with the

statute as interpreted by said cases, and is recognized by the Commissioner of Internal Revenue in his own regulations since 1934. It is fair and equitable.

The judgment should be affirmed.

Respectfully submitted,

GIBSON, DUNN & CRUTCHER,
By BERT A. LEWIS,
Attorneys for Appellee.

APPENDIX.

United States Court of Appeals, for the Second Circuit.

No. 26—October Term, 1948.

(Argued October 6, 1948. Decided November 29, 1948.)

Docket No. 20999.

Commissioner of Internal Revenue, Petitioner, v. Susan J. Carter, Respondent.

Before L. Hand, Swan and Chase, Circuit Judges.

Petition to review a decision of the Tax Court of the United States.

The Commissioner seeks reversal of a decision of the Tax Court holding that income received by the taxpayer in 1943 was taxable as capital gain rather than as ordinary income. 9 T. C. 364. Order affirmed.

Theron Lamar Caudle, Assistant Attorney General, Lee A. Jackson and Irving I. Axelrad, Special Assistants to the Attorney General, for petitioner.

John S. Keith, Attorney for respondent.

Swan, Circuit Judge:

This appeal presents the question whether income received by the taxpayer in 1943 is taxable as long-term capital gain, as the Tax Court ruled, or as ordinary income as the Commissioner contends. The facts are not in dispute. The taxpayer, Mrs. Carter, had owned for ten years all the stock of a corporation which was dissolved on December 31, 1942. Upon its dissolution all of its assets were distributed to her in kind, subject to

all its liabilities which she assumed. In the distribution she received property having a fair market value exceeding by about $20,000 the cost basis of her stock, and she reported such excess as a capital gain in her 1942 return and paid the tax thereon. In the corporate liquidation she also received 32 oil brokerage contracts which the parties stipulated had no ascertainable fair market value when distributed. Each contract provided for payment to the corporation of commissions on future deliveries of oil by a named seller to a named buyer. The contracts required no additional services to be performed by the corporation or its distributee, and the future commissions were conditioned on contingencies which made uncertain the amount and time of payment. In 1943 the taxpayer collected commissions of $34,992.20 under these contracts. She reported this sum as a long-term capital gain; the Commissioner determined it to be ordinary income. The Tax Court held it taxable as capital gain. The correctness of this decision is the sole question presented by the Commissioner's appeal.

Mrs. Carter's stock was a "capital asset" as defined by section 117(a) of the Internal Revenue Code, 26 U. S. C. A., 1940 edition. In exchange for her stock, she received the assets of the corporation upon its dissolution. The tax consequences of such a transaction are controlled by section 115(c) which provides that "the gain or loss to the distributee resulting from such exchange" shall be determined under section 111 but recognized only to the extent provided in section 112. Turning to section 111(a): the "gain from the sale or other disposition of property" is the excess of "the amount realized therefrom" over the adjusted cost basis provided in section 113(b). Paragraph (b) of section 111 defines the

"amount realized from the sale or other disposition of property" to be the sum of money received "plus the fair market value of the property (other than money) received." Paragraph (c) of the same section provides that "In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112." That section lays down the general rule, subject to exceptions not pertinent to the case at bar, that "upon the sale or exchange of property" the entire amount of the gain or loss, determined under section 111, shall be recognized. From the foregoing statutory provisions, it is obvious that if the oil brokerage contracts distributed to the taxpayer had then had a "fair market value," such value would have increased correspondingly the "amount realized" by her in exchange for her stock and would have been taxable as long-term capital gain, not as ordinary income. Boudreau v. Commissioner, 5 Cir., 134 F. 2d 360; Fleming v. Commissioner, 5 Cir., 153 F. 2d 361. The question presented by the present appeal is whether a different result is required when contract obligations having no ascertainable fair market value are distributed in liquidation of a corporation and collections thereunder are made by the distributee in later years.

In answering this question in the negative, the Tax Court relied primarily upon Burnett v. Logan, 283 U. S. 404. That involved a sale of stock, not a distribution in liquidation, under which the seller received cash and the buyer's promise to make future payments conditioned on contingencies. The cash received did not equal the seller's cost basis for the stock, and the contingencies af-

fecting future payments precluded ascribing a fair market value to the buyer's promise. In later years payments were made which the seller did not return as income. The decision held that she was not required to do so. With respect to such payments, the court said, pages 412-413:

"As annual payments on account of extracted ore come in they can be readily apportioned first as return of capital and later as profit. * * * When the profit, if any, is actually realized, the taxpayer will be required to respond. The consideration for the sale was $2,200,000.00 in cash and the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one. Respondent might never recoup her capital investment from payments only conditionally promised. * * * She properly demanded the return of her capital investment before assessment of any taxable profit based on conjecture."

The Commissioner argues that the Logan case is inapplicable because there the taxpayer had not recovered the cost basis of her stock while here she had. The Tax Court thought the distinction immaterial. We agree. The Supreme Court spoke of the annual payments as constituting "profit" after the seller's capital investment should be returned. Until such return it cannot be known whether gain or loss will result from a sale; thereafter it becomes certain that future payments will result in gain. No reason is apparent for taxing them as ordinary income. As this court said in Commissioner v. Hopkinson, 126 F. 2d

406, 410, "payments received by the seller after his basis had been extinguished would have been taxable to him as capital gains from the sale of the property," citing Burnet v. Logan as authority.[1]

The Commissioner also urges that the Logan case is distinguishable because it dealt with a sale of stock rather than exchange of stock for assets distributed in a corporate liquidation. This contention is answered by White v. United States, 305 U. S. 281, 288, and Helvering v. Chester N. Weaver Co., 305 U. S. 293, 295, where the court held that the recognition required by section 115(c) of gains and losses on liquidation must for purposes of computation of the tax, be taken to be the same as that accorded to gains and losses on sales of property. Consequently we agree with the Tax Court's ruling that the principle of the Logan case is applicable to a corporate liquidation where stock is exchanged in part for contracts having no ascertainable market value, and that future collections under such contracts are taxable as capital gain in the year when received if the distributee has previously recovered the cost basis for the stock.

The Commissioner's argument that such collections are analogous to the receipt of interest or rent upon bonds or real estate distributed in a corporate liquidation overlooks a significant distinction. Payment of interest or rent does not impair the value of the bond or real estate since each remains as a capital asset regardless of the number of payments. See Helvering v. Manhattan Life

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[1]For similar rulings see Haynes v. United States, 50 F. Supp. 238 (Ct. Cls.); United States v. Yerger, 55 F. Supp. 521 (D. C. E. D. Pa.); Hill's Estate v. Maloney, 58 F. Supp. 146 (D. C. N. J.); Nicholson v. Commissioner, 3 T. C. 596.

Ins. Co., 2 Cir., 71 F. 2d 292, 293. But with respect to the oil brokerage contracts, under which no additional services were to be rendered by the payee, each payment decreases their value until, with the final payment it will be completely exhausted; and, if the payments be treated as income, the distributee has no way to recoup his capital investment, since concededly he has no economic interest in the oil producing properties and therefore no right to depletion deductions.[2] Hence to consider the brokerage payments as ordinary income would produce a most unjust result and one quite unlike the result which follows the distribution of bonds or real estate in a corporate liquidation.

For the foregoing reasons we think the decision of the Tax Court correct. It is affirmed.

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[2]It is true, in the case at bar, the taxpayer had no capital investment in the brokerage contracts because from other assets distributed she had already recovered the cost basis of her stock and the oil brokerage contracts had no ascertainable fair market value. But the Commissioner's analogy argument would be equally applicable if the brokerage contracts had been the only corporate assets distributed and it had been possible to ascribe to them a fair market value of $21,000. In that case, the distributee's capital investment in the brokerage contracts would have been $20,000, the cost basis of her stock being $1,000. She would be entitled to recover her capital investment before she could be charged with receiving either gain or ordinary income, and the only source of recovery would be the payments which would ultimately exhaust the value of the contracts. Hence the answer given above to the analogy argument is apposite.